United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7565

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

PITTSBURGH COKE & CHEMICAL COMPANY,

Plaintiff-Appellant,

-against-

LOUIS J. BOLLO,

Defendant-Appellee.

Appeal from a Judgment of the United States District Court for the Eastern District of New York

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BRIEF OF DEFENDANT-APPELLEE

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INDEX

	Page
PRELIMINARY STATEMENT	1
STATEMENT OF THE CASE	4
The History of Standard and its Activities	4
PCC's 1967 Acquisition	9
The Second Acquisition	11
PCC's Investigation of Standard	15
The 1969 Closing and Post-Closing Events	18
The Lawsuit	20
The Alleged Fraud -- Relationships with Suppliers	21
A. Pre-December, 1968 Events	22
1. Bendix N&C -- Change in Discount Rate	22
2. Bendix E&C -- Change in Discount Rate	24
3. The Claimed Instability of the Whittaker Distributorship	27
B. Post-Contract, Pre-Closing Events	28
1. Whittaker Telex of February 6, 1969	28
2. Bendix N&C Letter of April 11, 1969	30
C. Post-closing Events	32
1. The Whittaker Cancellation of July, 1970	32
2. The Bendix Cancellation of September, 1970	33

Page

The Alleged Fraud -- Inventory Write-Off Policy 33

Standard's Write-Off Policy 35

Plaintiff's Experts -- Messrs. Christopher and Carolla 36

ARGUMENT 38

I EVENTS OCCURRING AFTER THE COMMITMENT TO PURCHASE ARE OUTSIDE THE REACH OF RULE 10b-5 38

II THE DISTRICT COURT REGARDLESS OF THE RADIATION DYNAMICS DOCTRINE FOUND THAT PCC FAILED TO PROVE SECURITIES FRAUD WITH RESPECT TO THE POST-CONTRACT EVENTS 44

A. Reliance 45

B. Materiality 48

C. The District Court's Findings Were Not Clearly Erroneous 51

III PLAINTIFF FAILED TO PROVE SCIENTER WITH RESPECT TO THE SECURITIES FRAUD CLAIMS 55

IV PLAINTIFF FAILED TO PROVE BREACH OF WARRANTY WITH RESPECT TO INVENTORY 57

V PLAINTIFF FAILED TO PROVE DAMAGES 61

CONCLUSION 66

TABLE OF AUTHORITIES

	Page
Barnett v. Kirshner, 527 F.2d 781 (2d Cir. 1975)	43
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)	55
Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975)	48
Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27 (2d Cir. 1976)	46
Hirsch v. DuPont, CCH Fed. Sec. L. Rep. ¶ 95,645 (S.D.N.Y. 1976)	50
Jackson v. Oppenheim, CCH Fed. Sec. L. Rep. ¶ 94,894 (S.D.N.Y. 1974)	48
List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965)	48
Mittendorf v. J. R. Williston & Beane, Inc., 372 F. Supp. 821 (S.D.N.Y. 1974)	49
Pittsburgh Coke & Chemical Company v. Louis J. Bollo, 421 F. Supp. 908 (E.D.N.Y. 1976)	passim
Pollak v. Eastman Dillon, CCH Fed. Sec. L. Rep. ¶ 94,9987 (S.D.N.Y. 1975)	47
Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876 (2d Cir. 1972)	2, 39-43
REA Express, Inc. v. Interway Corp., 410 F.Supp. 192, 199 (S.D.N.Y.), reversed, 538 F.2d 953 (2d Cir. 1976)	47
Spielman v. General Host Corp., 402 F. Supp. 190, 194-95 (S.D.N.Y. 1975), aff'd, 538 F.2d 39 (2d Cir. 1976)	50, 55
Titan Group, Inc. v. Faggan, 513 F.2d 234 (2d Cir.) cert. denied, 423 U.S. 840 (1975)	45, 46, 49
TSC Industries, Inc. v. Northway, 426 U.S. 438 (1976)	50

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-against-

LOUIS J. BOLLO,

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BRIEF OF DEFENDANT-APPELLEE

This is an appeal by plaintiff-appellant Pittsburgh Coke & Chemical Co. ("PCC") from a final judgment of the United States District Court for the Eastern District of New York (Neaher, D.J.) after a four day non-jury trial. The district court entered judgment in favor of defendant-appellee Louis J. Bollo ("Bollo") dismissing the complaint.*

Preliminary Statement

Simply stated, PCC's main claim in the district court was that Bollo, in connection with the sale of his controlling stock interest in Standard Aircraft Equipment Co.

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* The district court's opinion (JA 830-87) is reported at 421 F. Supp. 908.

("Standard") to PCC, committed fraud.

Judge Neaher, after an exhaustive analysis of the conflicting evidence (both the testimony and the documents) concerning every contention urged by PCC in support of its fraud claim, found (JA 870-71):

> "In sum, far from proving fraud, the facts and circumstances developed in the evidence establish the absence of any material non-disclosures or misrepresentations of fact. It also clearly appears that PCC was the active, sophisticated seeker of investment opportunities; that in acquiring Standard it acted in accordance with well-defined long range investment objectives; that PCC's representatives were men of business skill and acumen well able to deal with Bollo, who took full advantage of the protracted opportunity they had to examine the financial status of Standard prior to closing the deal; and that the acquisition was consummated on the basis of PCC's own assessment of Standard and its compatibility with PCC's entry into the airline business and not in reliance upon the matters alleged in this suit. See Titan Group, Inc. v. Faggen, 513 F.2d 234 (2d Cir. 1975), holding that in a case such as this, where both misrepresentations and material omissions are alleged, a plaintiff must show both materiality and reliance - a burden PCC did not meet here."

Those findings are all supported by substantial evidence; surely they are not clearly erroneous.

On appeal, PCC makes two major arguments:

(a) First, PCC asserts that in determining its Rule 10b-5 claim, Judge Neaher, relying on this Court's decision in Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876 (2d Cir. 1972), erroneously looked only at the alleged claims

of fraud which were said to have occurred prior to the date when PCC contracted to purchase Bollo's stock in Standard. And, although Judge Neaher, in connection with PCC's common law fraud claims, carefully and methodically examined all of the alleged claims of fraud which were said to have occurred between the date of contract and the date of closing (and rejected all of them, relying in part on Rule 10b-5 cases), his error in applying Radiation Dynamics, according to PCC, "colors" all else and

> "... it may be that the trial court would have ruled otherwise on questions relating to materiality and the like had it taken a different -- and, we believe, more correct -- view of Bollo's legal obligations under rule 10b-5." (PCC Brief p. 39)

(b) Then, without even token reference to the mandate of Rule 52, Fed. R. Civ. Pr. -- "Findings of fact shall not be set aside unless clearly erroneous" -- PCC asks this Court to re-try the bulk of its fraud claims against Bollo.

We shall demonstrate that there is no merit in any of these arguments. The district court, we submit, correctly followed this Court's precedents regarding the appropriate time frame for determining if Rule 10b-5 had been violated.

But equally important, the district court went on to consider all of PCC's allegations of non-disclosure and misrepresentation, regardless of when they were claimed to have occurred and found, as a matter of fact on the basis of conflicting evidence as to critical facts, that PCC had utterly

failed to prove common law fraud, breach of warranty and (relying on Rule 10b-5 cases) two essential elements of a federal securities fraud claim -- materiality and reliance. Hence, even if there were legal error, it was harmless -- it surely did not "color" all else.

And, as to PCC's efforts to have its case re-tried in this Court, the short answer is that the district court's findings have a solid foundation in the evidence; the district court's conclusion of no liability is inescapable from those findings under any legal standard.

Statement of the Case*

The History of Standard and its Activities

The growth of Standard from a two-man service operation at Roosevelt Field, Long Island in 1933 to a corporation with over $9 million of sales and five regional distribution centers in 1969, was due in large measure to the energy, hard work and business skill of Louis Bollo. Standard began as a sole proprietorship owned by defendant Bollo in 1933.** The

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* Where the trial court made specific findings of fact, reference is made herein to the trial court's decision as well as to the portions of the record supporting those findings.

** Bollo's personal background before the formation of Standard was as follows: he had to leave high school after three years for economic reasons and never received his diploma (JA 538). He became an airplane mechanic and pilot (JA 539), and worked for Pioneer Instrument Company at its New York service station (JA 539). In 1933, during the depression when Pioneer determined to close this New York station, Bollo purchased the business from Pioneer for a modest sum, to be paid out of future earnings (JA 540-541), and named the business Standard.

business was not incorporated until 1947. In the 1930's, Standard functioned primarily as a service facility, repairing and maintaining aircraft instruments and accessories, and, to a lesser degree, as a distributor of aircraft parts for manufacturers (JA 542-543). Standard's customers in those days were primarily individuals -- the aviation pioneers (JA 543; JA 831).

Beginning with the World War II years, however, the emphasis of Standard's business began to shift. The distribution -- or sales -- part of the business grew dramatically; the service part of the business grew also, but not at the same rate (JA 545). Having started out with a distributorship for one supplier in 1933, by 1969 Standard represented approximately 100 suppliers each with distinct product lines (JA 546). And Standard's major customers in 1969 were now, in varying proportions, the commercial airlines, Pan Am, TWA, American, etc. -- 45%, fixed based operators and repair centers -- 40%, corporate aircraft operators -- 14% and the military -- 1% (JA 1195-1196; JA 831-32).

Standard's principal manufacturer-suppliers from 1965-1972 were Bendix Aviation Corp. (through a number of separate divisions), Whittaker Corp., Goodyear Tire & Rubber, Champion Spark Plug, Sonotone and Pesco Products Division of Borg-Warner (JA 894). Whittaker and the two Bendix Divisions singled out for special consideration by PCC in this

lawsuit,* accounted for $3.2 million of Standard's $6.6 million sales in 1966 and $4.9 million of its $9.1 million 1968 sales. It is significant that these suppliers still accounted for $3 million out of $8.7 million of Standard's 1970 sales (JA 832; JA 894).**

Standard sold both units, complete assemblies such as generators ready to go on an engine or airplane, and "piece parts," the spare part that goes into the unit such as brushes in a generator. By 1968, the major portion of Standard's income was the result of its sales of aircraft "piece parts" of the 100 manufacturers it represented to its many customers. The breakdown of its business was 95% piece parts and 5% units (JA 546-548; JA 834).

As Judge Neaher found (JA 833):

> "The essence of Standard's business was aptly characterized by Bollo as having 'the right part, in the right place, at the right time.'"

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* The two Bendix Divisions were the Navigation & Control Division ("Bendix N & C") and the Energy Controls Division ("Bendix E & C").

** With regard to Standard's sales for the 1968-1972 period, a time frame covering the year immediately preceding PCC's acquisition of its controlling interest and subsequent years, the district court found (JA 840-41):

> "For the year 1968 Standard's sales were 9.1 million, an increase of 17% over 1967 sales of 7.8 million, but net profits declined by $39,125. This decline was in substantial part attributable to a federal income tax surcharge. DX KK. In 1969 annual sales increased again to 9.27 million. PX 1. In 1970 -- characterized as the year of the 'aviation recession' -- sales dropped to 8.7 million, followed by a further drop in 1971 to 7.9 million. Id. In 1972, however, sales rose to 10.8 million, the highest in Standard's 39 year history."

Having the right part, in the right place, at the right time, was also the key to Standard's success. Since Standard had no exclusive distributorships, its customers could purchase the replacement parts they needed either from Standard, from one of Standard's competitors or directly from the manufacturer. The price to the customer would be the same since Standard and its competitors purchased parts from the manufacturers at an identical discount off the list price fixed by the manufacturer and sold the parts to their customers at the same higher price "suggested" by the manufacturer, which was also the same price at which the manufacturer might sell the part to the customer (JA 563-566; JA 833).

Since for all intents and purposes there was no price competition, for Standard to make the sale, it had to have the part the customer needed when the customer called for the part -- and Standard had to have the part at a geographical location where it could be promptly delivered to the customer. The quick and comprehensive servicing of customer orders was essential.

Standard's profits were realized from the differential between the discount it received from its suppliers and the "suggested" resale price it was able to realize on sales to its customers, after expenses. Between 1961 and 1967, Standard's gross profit margin was between 20% and 23% (JA 834).

The existence of companies such as Standard was useful both to the manufacturer and the airlines:

(a) Standard's suppliers -- e.g., Whittaker, the ten divisions of Bendix, Champion, Goodyear, etc. -- were prepared to have their parts distributed through companies such as Standard because the distribution companies were willing to make the capital investment in inventory and facilities required to permit the rapid servicing of customer requirements. Without distributors, the suppliers themselves would have had to commit their own capital to inventory requirements (JA 574).

(b) Standard's customers, e.g., the commercial airlines, etc. were willing to deal with Standard because their requirements for parts could be met promptly and efficiently out of Standard's inventory and from a location near the customer's base (JA 833).*

Thus, to satisfy both its suppliers' and customers' needs, Standard maintained an extensive inventory. Quantitatively, the inventory consisted of 50,000 to 60,000 different items. Qualitatively, the inventory ranged from a 5¢ washer to expensive and sophisticated aircraft instruments costing as much as $20,000 (JA 572), with over 99% of the items costing under $500 (JA 573; JA 834).

The volume of inventory Standard carried was important both to the manufacturer and the customer. For example,

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* Standard had regional branches at key locations: Garden City (Pan Am overhaul base), Los Angeles and Kansas City (TWA overhaul bases), Miami (Eastern overhaul base), and Atlanta (Delta overhaul base) (JA 833).

Standard stocked "insurance" items in its inventory which were parts that might be infrequently required by a customer, but when needed and rapidly delivered, greatly enhanced Standard's good will with the customer (JA 872).

Manufacturers similarly demanded that Standard maintain an extensive inventory. On one occasion, the Scintilla Magneto Division of Bendix cancelled Standard's distributorship because the supplier was of the view that Standard was not carrying a sufficient inventory of that supplier's parts (JA 574; JA 880).

Standard's relationships with its suppliers, therefore, were anything but risk-free. Apart from the foregoing, the contracts between Standard and its suppliers were non-exclusive and were generally cancellable by the suppliers on 30 days' notice (JA 561). And, these contracts permitted the manufacturer unilaterally to alter the discount rate to Standard at any time (JA 562; JA 833).

PCC's 1967 Acquisition

In early 1967, Standard and PCC representatives began discussions of a possible private placement of Standard's stock (JA 164). PCC wanted to invest in the aircraft parts business and Standard had a continual need for capital because of its inventory requirements.*

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* From 1947 until 1969, while Bollo was the chief stockholder, president and chairman of the Board, Standard did not pay any cash dividends on its stock but reinvested its profits in the business (JA 553). In 1959, Standard offered 75,000 of its shares to the public at a price of $4 per share (JA 1097). The proceeds of the public offering were used by Standard to augment its working capital (JA 552).

PCC, as the district court found, was a substantial diversified management investment company registered under the Investment Company Act of 1940. It had begun in 1964 an active program of conglomerate acquisitions, acquiring four wholly owned operating companies and significant holdings in several other affiliated and unaffiliated companies. As of December 3, 1968, PCC's net equity in operating companies and investments exceeded $56,000,000 (JA 831). PCC was in the business of buying and selling companies.

PCC's interest in an acquisition in the aircraft parts business coincided with its acquisition in 1967 of American Flyers, a supplemental airline. The trial court noted PCC's obvious intention to develop, through American Flyers, a commercial airline business and complement it with an aircraft parts and maintenance business (JA 835).

Mr. Richard M. Johnston,* then assistant to PCC's president, studied Standard's financial data and statements, visited Standard and discussed its business with Bollo and, for comparison, investigated Standard's principal competitors -- Van Dusen, Southwest Air Motive, Pacific Air Motive, and Air Work (JA 165-66, 175). Thus, the district court found PCC as early as 1967 "to have been fully cognizant of Standard's

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* Mr. Johnston testified at the trial as a witness for PCC. He was obviously a businessman of great skill and acumen. Among other things, he had received his Masters of Business Administration degree from the Wharton School of Finance and Commerce at the University of Pennsylvania (JA 163).

basic financial data over a considerable time period as well as its position in the field" (JA 836).

Mr. Johnston's investigation obviously satisfied him that an investment by PCC in Standard was worthwhile. So prior to June, 1967, PCC purchased some 23,000 shares of Standard's stock in the open market from Standard's public stockholders (JA 891; JA 174). And on June 8, 1967, PCC, Standard and Bollo entered into an agreement pursuant to which PCC purchased a total of 84,000 shares -- 64,000 shares of treasury and authorized, but unissued shares, from Standard and 20,000 shares from Bollo, all at a price of $7 per share (JA 1114). Thus, by June, 1967, the cost of PCC's equity investment in Standard exceeded $735,000 and, in percentage terms, its interest was about 25% of the outstanding shares (JA 836).

After the June, 1967 transaction, defendant Bollo in recognition of PCC's substantial equity position in Standard, offered a seat on Standard's Board of Directors to PCC. Mr. Johnston, on behalf of PCC, declined the offer because PCC had too many other things going on (JA 668; JA 836).

The Second Acquisition

In the fall of 1968 -- "the boom year for conglomerate acquisitons," as the district court noted (JA 836) -- PCC's attention returned to Standard. On September 27, 1968, Mr. Johnston reported to PCC that Premier Industries of Cleveland had had discussions with Bollo regarding a takeover of Standard and, indeed, had made a formal offer to Bollo for

his controlling stock interest. The district court found that Premier's offer "triggered PCC's virtually total acquisition of Standard" (JA 837).

Bollo feared that Premier, because of another recent acquisition, might not be in a position to supply Standard with the capital it needed and inquired whether PCC "would be interested in buying Standard and supplying the necessary aid" (JA 984; JA 837-38).

PCC reacted promptly. Henry L. Hillman, PCC's chairman and president, negotiated directly with Bollo in October, 1968. Bollo insisted on a price of $16 per share. Mr. Hillman initially offered less, based on PCC's determination of an appropriate multiple of earnings for Standard's stock (JA 670), but in a few days agreed to Bollo's price of $16 (JA 838).*

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* Although there was some suggestion at the trial that PCC had paid a "premium" for Bollo's shares, the district court found to the contrary (JA 868-69).

> "PCC's further suggestion, through Johnston's testimony, that the $16 per share it agreed to pay was a 'premium' based on Standard's anticipated earnings growth and not its current earnings evaluation is not in accord with the market facts. In December 1968 when the agreement was signed, Standard's stock was selling in the over-the-counter market at $16 per share, or 23.5 times its earnings. DX NN. In or about September, Premier Industries had offered to pay $15 cash to Standard public stockholders, p. 8 supra. PCC could hardly have offered less and the $1.00 it added was clearly designed to induce a favorable response to its tender offer. Nor was that price a 'premium' for Bollo's control stock over the $12.50 in convertible debentures Premier had offered him. PCC actually acquired a total of 434,002 of Standard's shares (97%) for $5,565,708, PX 1, ¶¶ 1 and 2, which averages out to $12.75 a share, a clear indication that Johnston had priced the deal for PCC with fair precision on the basis of Standard's earnings history and not on any anticipated earnings growth. DX F."

Under the agreement, PCC obligated itself to make a tender offer to Standard's public stockholders at a price of $16 per share; defendant Bollo agreed to sell to PCC at the price of $16 per share such additional shares as were not obtained by the tender offer so as to enable PCC to acquire an 80% interest in Standard; and Bollo had the option of "putting" his remaining shares to PCC at a later time at a price formula which guaranteed him $12 per share.*

The tender offer to the public was made on December 31, 1968 (JA 1254) and remained effective until February 13, 1969 (JA 127). PCC acquired 71,309 shares of the approximately 85,000 shares in the hands of the public for a total consideration of $1,140,944 (JA 892). At the closing on September 18, 1969, PCC acquired 171,302 Standard shares from Bollo for a total consideration of $2,740,832 (JA 892).

And in August, 1970 -- almost a year after the September, 1969 closing -- Bollo exercised his option and PCC, without alleging fraud, breach of warranty or anything else for that matter, paid Bollo $948,504 for 79,042 additional shares of Standard (JA 838-39).

Although the agreement contemplated that the closing with Bollo would take place no later than June 30, 1969, the closing did not, in fact, take place until September 18, 1969

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* The December, 1968 agreement also provided that Bollo and Standard would enter into an employment agreement (JA 906).

(JA 892). The delay was caused because the transfer of control to PCC required both SEC and CAB approval (JA 839).

The warranties contained in the 1968 agreement were identical to those contained in the earlier 1967 agreement (see pp. 9-11, supra). Paragraphs 2(e) and (f) of the agreement provided:

> "2. Bollo hereby warrants and represents as follows:
>
> * * *
>
> (e) There have been furnished to Purchaser financial statements of Standard, consisting of balance sheets as of December 31, 1965, December 31, 1966, and December 31, 1967, and income statements and related notes for the years ending December 31, 1965, December 31, 1966, and December 31, 1967, accompanied in each instance by the opinion of Byrnes & Baker, Certified Public Accountants, and a balance sheet as of September 30, 1968 and an income statement for the nine-month period then ended, prepared from the books and records of Standard without audit. Except as otherwise specifically set forth in said statement or in the accompanying accountants' certificates, all such financial statements have been prepared in accordance with generally accepted accounting principles applied on a consistent basis throughout the periods involved. All such statements fairly present the financial position of Standard as of the dates thereof and the results of operations for the periods indicated.
>
> (f) Since December 31, 1967, there has been no material adverse change in the financial condition or in the business or operations of Standard."

Paragraph 6(d) of the agreement provided:

> "6. The obligation of Purchaser to purchase the Balance of 80% of Standard Stock is subject to fulfillment of each of the following conditions:
>
> * * *
>
> (d) The representations and warranties contained in Paragraph 2 of this Agreement shall be true and correct as of the Closing Date, with the same force and effect as though they had been made at the Closing Date, and there shall have been delivered to Purchaser the certificate of Bollo, President of Standard, dated the Closing Date to such effect, . . ."

PCC's Investigation of Standard

We have already mentioned Mr. Johnston's early investigations of Standard prior to the 1967 acquisition by PCC of a substantial stock interest in Standard. In September, 1968, he updated his prior analysis, comparing Standard's operations in the first eight months of 1968, with its operations for the prior seven-year period (JA 836-37). Thereafter, he bowed out of the picture and responsibility for the acquisition fell on the shoulders of Putnam B. McDowell, a vice-president and director of PCC.*

Before the December 1968 contract was signed, Mr. McDowell asked his assistant for planning and control, Rodney

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* Mr. McDowell, like Mr. Johnston, also testified at the trial. He, too, was obviously a businessman of great skill and acumen. Among other things, he had received his graduate degree in business administration from the Harvard Business School (JA 86-87).

L. Bonar, a person "well trained in business administration" (JA 849)* to review Mr. Johnston's financial analyses to make sure there were no "red flags" (JA 858).

And, as the day of closing approached, PCC's "surveillance" of Standard's activities intensified. The district court found (JA 858):

> "There is not the slightest doubt that the financial results of Standard's business operations -- the only material information of interest to PCC -- were an open book. Indeed, before McDowell signed the December contract, he made sure there were no 'red flags' by having Bonar review Johnston's financial analyses, p. 20, supra. Surveillance of Standard's financial health and progress became even more intensive as McDowell took hold and the day of closing approached. PX 8, DX II, DX JJ, PX 9, DX D, DX G."

Thus, between December, 1968 and September, 1969, Messrs. McDowell, Bonar, Stoll and other PCC representatives visited Standard's offices at Garden City (JA 147-48, 672-74).

The reasons for the 1969 pre-closing visits, among others, were to allow PCC's representatives to gain sufficient familiarity with Standard's business so that there could be a smooth transition after the closing. Mr. Bonar, who looked for "red flags" in 1968, explained on the witness stand that his assignment on his July 1969 visit to Standard was: "to examine the company to determine the critical variables ... profit variables, to find out what we would be watching for or examin-

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* Mr. Bonar, like Mr. McDowell, had obtained his graduate degree in business administration from the Harvard Business School (JA 192), and was a witness at trial called by PCC.

ing as to the profitability of the company" (JA 194; JA 849). Just prior to the closing, Mr. Bonar visited Standard again; his memorandum of that visit (JA 1054-62) was a review of Standard's actual and estimated sales, earnings and margins and its new business and customers (JA 852-53).

A general procedure was followed on the many occasions when PCC representatives visited Standard: they would first meet with Bollo, he would find out what they were interested in learning and he would then turn them over to the officers or employees of Standard who could be useful to them. Mr. McDowell acknowledged that he never encountered any difficulty in having his questions answered by Standard personnel or getting the documents he wanted and that he did not receive reports from anyone else at PCC of any such problems (JA 156-57, 187-88; JA 854). Messrs. Jerome Bollo and Rushia, two witnesses employed by Standard at the time, but called by PCC at the trial, testified that they never received any instructions from defendant Bollo to withhold information or documents from PCC, and, indeed, they did not do so (JA 344-45, 378).

It is not exaggeration therefore, to conclude as the district court did, that virtually from the time of PCC's first investment in Standard and, surely, during the entire 1969 post-contract, pre-closing period, the affairs of Standard "were an open book" to PCC (JA 858).

And, clearly, the sophisticated businessmen at PCC were amply talented to take full advantage of the "openness" provided to them.

The 1969 Closing and Post-Closing Events

At the closing on September 18, 1969, defendant Bollo delivered a certificate to PCC in satisfaction of his obligations under paragraph 6(d) of the December, 1968 agreement. The certificate Bollo submitted -- and PCC accepted -- in satisfaction of that obligation in its effective provisions, is a word-for-word copy of paragraph 2 of the original agreement, except for subparagraph (f), which reads, as follows:

> "Since December 31, 1967, there has been no material adverse change in the financial condition [or in the business or operations] of the company as evidenced by most recent balance sheet information, except that, as you know, earnings in 1969 have been reduced due primarily to the investment in start up expenses of our Kansas City operation."
> (omitted material is in brackets, added material underlined.)

Thus, the words in brackets "business or operations" in the December, 1968 agreement do not appear in the September, 1969 warranty and the representation as to change in financial condition of the company is qualified by the words underscored

above -- "most recent balance sheet information."*

After the closing, Mr. McDowell became chairman of the board at Standard while defendant Bollo continued as president under his new employment agreement.

In October, 1970, Bollo resigned at McDowell's request, but no mention was made of any dissatisfaction PCC had with its acquisition of Standard (JA 535-36). Indeed, for some five months thereafter, Standard continued to pay

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* At the trial, PCC asserted that Bollo had breached this warranty given at the closing. PCC has apparently abandoned that assertion on appeal. On that issue Judge Neaher found (JA 878a-79):

> "Turning now to the second branch of PCC's warranty claim, there is no merit to the contention that Standard's failure to share in the second generation jet parts business was a breach of the warranty that "[s]ince December 31, 1967, there has been no material adverse change in the financial condition or in the business or operations of Standard." PX 2, ¶ 2(f). There were to be sure technological and economic changes in the aviation industry which undoubtedly affected the business of all who had dealings with that industry. But to say that these extrinsic developments constituted material adverse changes in Standard's existing business or financial condition is patently unreasonable.
>
> Bollo undoubtedly hoped that the advent of the big jets would mean greater business for Standard, but it was business not yet existing or within reach. The decision of the manufacturers to deal directly with the airlines took nothing from Standard except great expectations. PCC may have shared those expectations but their dissolution did not destroy the business it purchased as Standard's 1972 sales figures show. There was no warranty against such an eventuality and none was breached."

Bollo the salary to which he was entitled under the employment agreement (JA 840).

The Lawsuit

Bollo's first notice that he was being charged with fraud and breach of warranty by PCC came on the day when he was served with the complaint in this lawsuit. In March, 1971 -- more than two years after the December, 1968 contract and more than 1 1/2 years after the September, 1969 closing -- PCC commenced this action against defendant Bollo seeking to recover from him $3,100,000 (approximately 85% of the consideration Bollo received) of the moneys it paid for the Standard shares it acquired in 1969 and 1970 from Bollo and the public.

The complaint advanced three separate legal theories for recovery:

1. Misrepresentations and material omissions in violation of Rule 10b-5;

2. Breach of warranties contained in the December, 1968 agreement and the certificate delivered by Bollo at the closing in September, 1969; and

3. Common law fraud (a claim abandoned on this appeal).*

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* Other claims were abandoned prior to trial. In the early stages of this lawsuit, PCC alleged two other claims of fraud:

1. Bollo's alleged failure to disclose that Standard did not carry product liability insurance; and

2. Bollo's alleged failure to disclose a claim for state sales taxes made against Standard immediately prior to the 1969 closing.

PCC offered no evidence at trial with respect to either of these two claims.

The alleged factual basis for all three claims, however, was essentially the same:

1. Bollo's alleged nondisclosure and affirmative misrepresentations with respect to a "worsening" of Standard's relationships with three of its principal suppliers: Whittaker, Bendix N&C and Bendix E&C.

2. The alleged overvaluation of Standard's inventory on its balance sheets due to the failure to follow "generally accepted accounting principles" in writing off inventory (on appeal, this claim is asserted only as a breach of warranty, not as fraud); and

3. Bollo's alleged misrepresentation of Standard's inventory write-off policy (a claim abandoned on this appeal).*

The Alleged Fraud -- Relationships with Suppliers

PCC's specific claims with regard to "worsening" relationships with suppliers fall into three time periods: (1) pre-contract events, (2) post-contract events and (3) post-closing events. The first category should be of no concern on this appeal since the legal error PCC asserts is the district court's failure to consider the events after contract in connection with its Rule 10b-5 claim. As to the second category, it is important to distinguish between what actually occurred and PCC's arguments as to what predictions were

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* The district court found no misrepresentation by Bollo of inventory write-off policy.

possible from the actual occurrences. The third category is significant because it encompasses events which Bollo is faulted by PCC for not being able to predict, and which the district court found "in all likelihood provoked this litigation" (JA 854).

A. Pre-December, 1968 Events

1. Bendix N&C -- Change in Discount Rate. By letter dated April 1, 1968, Bendix N&C advised Standard of a change in the discount rate on "commercial end items" -- or units (JA 1005). The change in discount rate substantially reduced the gross profit for distributors on sales of units.

The letter said, among other things:

> "As discussed with you during recent ADMA meetings, the commercial aircraft industry with its ever increasing competitive picture has created several financial and support problems for us. Bendix Navigation & Control Division has been most fortunate in winning a sizeable avionics package on the Boeing 747 and we hope to do the same on the SST and Airbus airplanes. . . .
>
> "We are now faced with the planning and paying the price for this success. . . ."

After announcing the change in discount rate, the letter went on to say:

> "We are encouraging all the airline customers to do their initial provisioning of end items spares through our distributors. We conservatively estimate on the 747 alone that there is a market potential from 1970 through 1975 of over $10,000,000. I believe that is quite an incentive for a distributor to get in with his airline customer and back him up with the support he expects." (JA 1006).

The evidence was uncontradicted that the N&C discount rate change had a minimal impact on Standard's business, affecting about 5% of Standard's total sales of N&C products (JA 291, 633-34).*

The district court found (JA 844):

> "Bollo testified without contradiction that the reduced discount on 'commercial end items' did not affect the bulk of Standard's N&C business, which was the sale of spare parts or 'piece' items as distinguished from 'end items' or units (e.g., an entire generator). He also pointed out a similar reduction had occurred when the Boeing 707 and BAC 111 first came into operation and equipment manufacturers sought to recapture their costs by passing part of them along to the distributors. After the initial provisioning period ended, Bollo testified, the discount rate returned to 'normal'."

In view of the foregoing, the district court had no difficulty in concluding that (JA 857)

> "... the April letter [from Bendix N&C], received almost six months before the proposal that PCC acquire Standard was even discussed, was hardly likely to be a reasonable subject of PCC interest. This is especially so when the discount reduction had no substantial impact on Standard's business of selling 'piece' parts rather than units to which the lower rate applied."

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* PCC contends (Br. p. 17) that this change in discount rate in 1968 on units meant an elimination of all Bendix N&C sales for Standard because of insufficient profit and an elimination of expected second-generation jet N&C sales. Yet, in 1969, Standard had $1,575,000 in sales in Bendix N&C products (JA 894). Those sales were eventually eliminated in later years because of the cancellation of the Bendix distributorship in 1970 -- not because of the 1968 discount rate change. And the Pan Am orders for 747 Bendix N&C units, which were made in late 1968 and early 1969, were cancelled in May, 1969 because of the April, 1969 N&C notice (JA 1012) re second-generation jet business, not because of the 1968 discount rate change (JA 847). PCC's Brief on this point (p.17) is simply in error.

2. Bendix E&C -- Change in Discount Rate. By letter dated October 30, 1968, Bendix E&C reduced its discount rate on "rotors, stators, and linings" -- a major portion of the wheel and brake product line that Standard sold (JA 1009). This discount rate change, however, did not eliminate the distributor's profit; it simply reduced the gross profit margin from 27.3% to 16.4%.

Of course, the decrease in the gross profit margin could be ameliorated by increases in the volume of sales of Bendix E&C products. And, in fact, in 1969 Standard entered into substantial contracts with United and Eastern for portions of their wheel and brake needs (JA 1046-47), and commenced a project to obtain the wheel and brake business of some foreign airlines. This so-called Atlas Project never came to fruition because of PCC's unwillingness to supply to Standard the needed capital (JA 157-58, 331-33, 644-46).

PCC tried to prove below, and now on appeal (PCC Br. p. 14), the alleged adverse impact of the E&C discount rate change by computing its effect on Standard's profits as if it were in effect in the period 1965-1968 (which it was not) and by ingnoring any increase in sales (which did occur).

The district court, however, dealt with the evidence in a much more realistic fashion. Judge Neaher found (JA 845):

> "The effect of the discount change was to reduce Standard's gross profit on the sale of such parts from 27.3% to 16.4%. The discount on all other E&C parts remained at the historical 60%. In the three-year period 1965-67, Standard's sales of E&C parts aggregated $3,921,000. PX 1.

For the three-year period 1968-1970, the overall total increased to $4,883,000. How much of these sales was affected by the discount reduction and its actual effect upon Standard's profitability was not shown." (Emphasis added.)

* * *

Bollo testified at trial that representatives of PCC were advised of both discount reductions, but he was not sure of the particular people or times (JA 637-39). Messrs. Johnston and McDowell testified they had no recollection of being so advised (JA 105, 170-71). The conflict is not irreconcilable; Mr. McDowell assumed no major role until after December, 1968 and Bollo had discussions with other PCC representatives during this period, such as Binger, Hillman, Adams and Stoll (see JA 123-24, 149-50, 669-74), whom PCC did not call to testify.

In any event, the district court expressly did not adopt an "'either/or' approach with respect to credibility" nor accede to PCC's demand that Bollo be branded "a liar" (JA 856-57). The court did not have to reach this credibility issue because it found that PCC was fully aware of the important facts concerning Standard's profit margins. Thus, for purposes of its decision, the district court accepted Mr. Johnston's and Mr. McDowell's testimony that they personally were unaware of the specific Bendix letters on discount reduction (JA 857).

Nevertheless the district court found, as follows (JA 857-58):

"The October letter [reduction of Bendix E&C discount rate] arrived shortly after the

'handshake deal' but obviously prior to the signing of the acquisition contract on December 20, 1968. It lowered the distributors' discount on certain parts to 54 percent, down from 60 percent, effective January 1, 1969. Since its effect would be to reduce profit margin on wheel and brake parts -- which Bollo estimated to be about 60 percent of the Bendix E&C product line handled by Standard -- it represented an arguably material development because of its impact on future earnings. Its claimed significance as an undisclosed fact vanishes, however, in light of PCC's microscopic scrutiny of Standard's profit margins, sales and earnings -- actual and projected -- over the ten year period 1961-1970. PX 10, DX F and G.

* * *

Prior to the closing, PCC was well aware that even though Standard's sales in 1969 were likely to increase over 1968 -- which they did, PX 1, ¶ 7 -- its net income after taxes for 1969 would decrease about 60 percent. See p. 24, supra, and DX G. PCC apparently did not question this substantial decline and went ahead with the closing. The inference is inescapable that it either knew the reasons21/ or considered them immaterial to its ultimate objectives in completing the acquisition."

And in footnote 21, the district court wrote (JA 884):

"Certainly the reduced discount on Bendix E&C brake and wheel parts (rotors, stators and linings) effective January 1, 1969, would have been one of the reasons for the decline in earnings for that year even though Standard was awarded a substantial two-year contract to handle Eastern Airlines' wheel and brake business. DX B and C. It is thus impossible to believe PCC was unaware that the expected net profit on that new business, as comptued by Bonar, DX G, was at the then current reduced Bendix discount rate."*

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* In addition, Mr. McDowell in his May, 1969 memo, commented on the problem of increased sales but decreased profits for 1969 and specifically stated that Bollo's "costs are increasing faster than his suppliers are permitting his selling prices and discounts to rise." (JA 973, emphasis added.)

3. The Claimed Instability of the Whittaker Distributorship.

PCC claimed below that Bollo was aware of facts which showed the "instability" of the Whittaker relationship, but which were never disclosed to any representative of PCC. PCC reiterates those claims on appeal. The facts, however, show that Standard's relationship with Whittaker was no more nor less "unstable" than other supplier relationships.

Beginning in 1959, Standard became Whittaker's only distributor -- but it never had any contractual exclusivity (JA 315). Indeed, at all times, Whittaker also distributed its own products in competition with Standard (JA 316).

In 1963, Whittaker sent a notice of cancellation of the Standard distributorship (JA 1064), but quickly reinstated it and, indeed, shortly thereafter increased Standard's territory from the eastern half to the entire United States (JA 318-20).

In 1966, Whittaker set up its Aircraft Components Division ("ACD") to take over the distribution function previously performed in-house. Standard countered with a Los Angeles branch to better service its west coast customers and easily met the competition coming from ACD (JA 342).

In 1967, two internal Whittaker documents (JA 986, 990) surreptitiously came into Standard's hands. The two documents, dated January and July 1967 (the latter is a rough, corrected draft) advocated that Whittaker management divert

Standard's business to ACD. But as the district court found: "Both were written by one Danks, an obviously ambitious subordinate desirous of increasing the importance of ACD but lacking the authority to effectuate his proposals" (JA 842).

In contrast to the the uncertain import (the second memo also pointed out the benefits of the Standard distributorship to Whittaker) and dubious authority of the memos, the distributorship itself was uninterrupted during 1967-69. And the district court found particularly significant Whittaker's renewal of the distributorship contract in April 1967 (JA 860). The district court concluded (JA 843):

> "In view of Whittaker's uninterrupted relationship with Standard during 1967, 1968, and 1969, and the ambiguous import of the memoranda, they cannot fairly be regarded as 'facts' which ought to have been brought to PCC's attention in 1968. . . ." [Footnote omitted.]

B. Post-contract, Pre-closing Events

1. Whittaker Telex of February 6, 1969. In early 1969 Jerry Bollo visited Whittaker in California and on his return, he addressed a "Personal Memorandum" to J. J. Davies (but not to his brother) concerning the visit (JA 1001). The memorandum reported the "probability" that Standard would not be handling Whittaker unit or spare part business on the second generation jets due "to the competitive situation." But the memorandum went on to say (JA 1002):

"We were complimented on the job we have done for the airlines and Harry assured me that our current jet program is secure for a minimum of two years."

A few days later -- on February 6 -- Whittaker, by telex, notified Standard that (JA 1003):

"In accordance with our recent discussions with Harry White, it is Whittaker's intent to accomplish all initial provisioning for the 747 aircraft through the controls division."

"Initial provisioning" is the airlines' first order of replacement units and parts for new airplanes which the CAB requires be stocked along their routes. "Follow-up support" refers to the replacement of those units and parts and constituted the "bulk" of Standard's business (JA 569).

There was nothing in the telex which suggested that Standard would not get the follow-up support business on Whittaker products for the 747.* Nor did the telex in any manner suggest that Standard's existing Whittaker business on the first generation jets, or the distributorship itself, would be eliminated.

On this subject, the district court found (JA 866-67):

"Although Standard's hope for increased sales growth when the big jets began service was undoubtedly a frequent subject of discussion with PCC officials, there is no convincing evidence of fraudulent representation on Bollo's part or that PCC was deceived into consummating the aquisition.

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* Jerry Bollo's interpretation -- still advocated by PCC (PCC Br. p. 11) -- that the telex was "understood" to extend to follow-up support was in conflict with defendant Bollo's testimony and the language of Whittaker's notification itself and was not accepted by the trial court (JA 846, 866).

The dismal prospects portrayed by PCC's broad strokes fade considerably when the evidence it relies on is closely examined in context with other facts.

> "For example, the Whittaker telex in February 1969, PX 15, which removed 'initial provisioning for the 747 aircraft' from Standard's future reach, could not have been a surprise to PCC. McDowell acknowledged he was aware prior to the closing of 'the possibility that the initial stocking might be performed by the manufacturers.' Tr. 36. Such a concession is fatal to any claim that PCC was induced to complete the acquisition by false representations of Bollo that Standard could count on increased sales supplying parts for the big jets."

2. Bendix N&C Letter of April 11, 1969. By letter dated April 11, 1969, Bendix N&C advised Standard that (JA 1012):

> ". . . with respect to our Navigation Control Division's products for the 747, DC-10, and other new programs, we have decided that as of May 1, 1969 we will serve the airline aftermarket on a factory-direct basis rather than through our distributors."

The letter continued

> "At the same time, I want to reiterate our sincere belief that aviation distributors have an important and effective role in serving our airline aftermarket, and that we look forward to continuing our distribution program for other products and aircraft."

In effect, this letter meant tnat Standard would play no role in the initial provisioning or follow-up support of Bendix N&C products on the second generation jets.*

* * *

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* After this letter was received, defendant Bollo advised Standard's sales personnel that they were not to quote at all on N&C units for the 747 and DC-10 aircraft (JA 1166). His memorandum, to that effect, was addressed to some 15 people.

The Whittaker telex and the N&C letter of April 11, 1969 had the impact of depriving Standard of some new second-generation jet business it had hoped to obtain.

Although Bollo testified that he kept PCC apprised of these developments (JA 624-25, 639-41), the trial court looked to PCC representatives' testimony and their own documents to find that PCC was aware of the status of Standard's jumbo jet business prospects.

Mr. McDowell, the PCC representative most likely to have been apprised in 1969, acknowledged that he was aware, prior to the closing, of "the possibility that the initial stocking might be performed by the manufacturers" (JA 112).

The trial court found McDowell's admission, especially when compared with his own memo from the same time period, "fatal" to PCC's claim.

McDowell's May 13, 1969 memorandum itemized new business prospects, such as Eastern and United wheel and brake business but was qualified by the reservation that Standard did not "expect to get all of this business" (JA 975). And conspicuously absent from the list is the $725,000 Pan Am order which was cancelled a few days before because of the Bendix N&C decision to eliminate distributors on 747 business. The district court, thus, reached the "obvious conclusion" (JA 869-70):

> "that McDowell omitted it from his list because he was aware that big jet business would not be available to Standard. . . ."

PCC now tries to argue that the Pam Am 747 business is absent from McDowell's memo because PCC was never informed of it. No PCC representative denied knowledge of this Pam Am business and Johnston's September, 1968 memo to McDowell specifically reports Standard's expectation of Pam Am's 747 business (JA 983).

Moreover, the inference from the McDowell memo is buttressed by another conspicuous absence. On September 5, 1969 just before the closing, Mr. McDowell wrote to defendant Bollo advising him of a trip by Mr. Bonar to review "preliminary" sales and earnings forecasts. Mr. McDowell said in his letter:

> "What we are looking for is in three parts.
>
> 1. Anticipated sales and earnings on the new major sales such as Eastern, United, NARCO, etc. This is for the purpose of backing up our investment in or loan of added working capital. . . ." (JA 1048).

Neither the May 1969 McDowell projections of new business, nor his September 1969 letter, nor Bonar's notes following his September 1969 visit, make reference to any Bendix N&C business for the 747's.

C. Post-closing Events

The story would not be complete without mention of events occurring about a year after the closing which, according to the district court, "in all likelihood provoked this litigation" (JA 854).

1. The Whittaker Cancellation in July, 1970. On July 27, 1970 -- long after the closing -- Whittaker notified

Standard of the cancellation of its distributorship agreement (JA 1066). It was to take effect in February, 1971.

2. The Bendix Cancellation of September 1970. On September 1, 1970, Bendix terminated its distributorship agreement with Standard as to the N&C and E&C divisions but not as to other Bendix product lines (JA 1066).

One other event occurred about this time -- Mr. McDowell became aware that Standard's supplier contracts were unilaterally cancellable on short notice, despite the fact that at least at trial he considered supplier relationships "a critical aspect of the business" (JA 137-38). McDowell had never asked to see the contracts and his assistant, Mr. Bonar, who had learned in 1969 that they were cancellable did not consider the information worthy of reporting to McDowell (JA 204-10, 139).

One final matter must be mentioned concerning the Whittaker and Bendix cancellations -- they occurred during what PCC's expert called the "aviation recession" (JA 521) and what McDowell called "the most severe credit crunch of a generation" (JA 157-58).

The Alleged Fraud -- Inventory Write-Off Policy

At trial, PCC asserted two claims concerning Standard's inventory write-off policy:

(a) that Standard failed to follow "generally accepted accounting principles" in writing off inventory; and

(b) that defendant Bollo affirmatively misrepresented Standard's write-off policy.

The district court found no misrepresentation by Bollo (JA 872) and PCC does not press that claim here.

In contrast to PCC's critical scrutiny of inventory at trial and on appeal, it is clear that at the time of PCC's acquisition of Standard in 1968 and 1969, PCC's representatives had not the slightest interest in Standard's write-off policies. Prior to the December, 1968 contract, no PCC representative ever inquired about what Standard's write-off policy was. Prior to the closing, no PCC representative ever determined how much inventory Standard had written off in prior years, or what the content or sales history of the inventory was in detail, despite unlimited access to the inventory itself, the inventory records and the inventory personnel of Standard.*

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* Mr. Bonar was the first PCC representative to inquire at all into Standard's inventory practices and this was months after the December, 1968 contract of sale. As might be expected for a company such as PCC that was making an acquisition based on earnings not net assets, Bonar (JA 977-82) focused on inventory turnover and inventory control. The one mention of a write-off policy in his memorandum -- the description of a 2-year rule -- proved to be in error. At trial Mr. Bonar testified that Louis Bollo told him such a 2-year rule existed and that Mr. Rushia and Peter Bollo both confirmed the existence of such a rule. But at trial Louis Bollo, Mr. Rushia and Peter Bollo all denied telling Mr. Bonar that such a policy existed (JA 594-95, 380-81, 746-49).

Standard's Write-Off Policy

There is no dispute as to the first aspect of Standard's write-off policy -- inventory items which became useless because they were defective, broken, obsolete, unsalable because of CAB regulations, missing or stolen, etc. were written off on a daily basis. No records of the amount of such write-offs were kept but they were clearly more than de minimis (JA 383-84, 583-85).

In the years 1962-69, end-of-year inventory write-offs totalled $137,000. In three of those years, however, there were no end-of-year write-offs (JA 892-93, JA 872). The items which were written off were not thrown away. They were kept in stock and it is undisputed that Standard would thereafter sell some of those items, either directly or through Standix, a subsidiary company which dealt with surplus and used parts (JA 589-90, 748-49).

There was an apparent conflict in the testimony as to exactly how end-of-year write-offs were determined. Bollo testified that in those years, Rushia, Standard's inventory man, would propose a list of items and Bollo would make the determination of what should be written off based on the sales prospects of the item, its cost, the amount in stock and his "37 years of experience in the business" (JA 586-88). Rushia testified that Bollo gave him an "arbitrary" dollar amount to be written off at the end of the year, that Rushia selected the actual items to be written off (based on lack of sales of the

item for a period of years) and that he stopped when he reached the figure supplied by Bollo (JA 348-54). The district court did not resolve any conflict in the details of these practices, but used Rushia's version to test PCC's claim that Standard's inventory was improperly valued.

Plaintiff's Experts -- Messrs. Christopher and Carolla

Mr. Christopher and Mr. Carolla both testified that Standard's write-off policies were inadequate.* From that testimony, PCC now claims that defendant Bollo breached his warranties of December 1968 and September 1969.

The essence of the Christopher and Carolla criticisms of Standard's write-off policies was the absence of some fixed formula which would mandate inventory write-offs if there were no sales activity during a given period of time.

But beyond that criticism, Mr. Christopher and Mr. Carolla were not in agreement as to what an appropriate formula might be. Mr. Christopher, for example, testified that he thought a two-year rule was reasonable, i.e., inventory write-offs if no sales for two years. The two-year rule, however, was not something he had thought up himself; rather, it was a formula which had been suggested to him by Standard's officials in 1970. And he conceded that one could not go to any standard

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* Actually, both opined only that Standard's method of writing off inventory, as testified to by Mr. Rushia, was inadequate (JA 406, 466-67). They said nothing about the policies described by defendant Bollo.

accounting textbook and find any authority for a two-year rule. He went on to testify that in his opinion a six-month rule "sounds like too short a period to me" (JA 417-20).

Mr. Carolla, on the other hand, pointed to a variety of formulas that were used in the aircraft parts business. For example, one of the major companies in the business, Southwest, had a six-month write-off policy (JA 466). It was Mr. Carolla's opinion that each of those formulas was reasonable; he indicated that he would not quarrel with a formula that was a reasonable exercise of business judgment in the circumstances (JA 513-14).*

In short plaintiff's expert testimony amounted to this: "Generally accepted accounting principles" required that some reasonable effort be made to write off material which had no reasonable sales prospects for the future.

PCC's specific claim was that in excess of $380,000 of inventory should have been written off by Standard during the 1962-69 period if the two-year rule had been applied (JA 1018, 405). But the trouble with that number is that it is based on a statistical sample, not an actual evaluation of the inventory items themselves.

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* It is unlikely Bollo could have obtained information on the write-off policies of his competitors since companies generally regard their inventory write-off policies as confidential matters (JA 421). And there was no trade association or other source for this information (JA 490).

As the district court found, no fraud was shown, just "conflicting evidence of business practice" (JA 873). Indeed, by "construing, 'generally accepted accounting principles' as a warranty that all inventory which might have been written off was in fact so treated," PCC really "challenges the business judgment of Standard's management in not taking greater advantage of liberal write-off opportunities" (JA 877).

The district court looked at the size of Standard's inventory, its importance to suppliers and customers (e.g. the value of an "insurance item"), the practices of small companies, the lack of textbook authorities, and the regular write-offs by Standard and CPA certification of its financials and concluded (JA 878a):

> "On the evidence the conclusion is unavoidable that PCC's expert computer assisted methods of inventory control cannot be made the standard for construing 'generally accepted accounting principles' and imposing liability for breach of warranty upon Bollo."

ARGUMENT

I

EVENTS OCCURRING AFTER THE COMMITMENT TO PURCHASE ARE OUTSIDE THE REACH OF RULE 10b-5

In ruling on PCC's Rule 10b-5 claims, the district court wrote (JA 862-63):

> "As already noted, there is no substantial evidence of material omission or misrepresentation on Bollo's part in the pre-commitment period

> to support PCC's Rule 10b-5 claim. At best its claim amounts to the assertion that Bollo's intimate knowledge of Standard's affairs required him to predict for PCC that Whittaker and Bendix's N & C and E & C Divisions would in 1969 decide not to use distributors for the sale of repair parts for the second generation jets; that in 1970 the 'aviation recession' would occur; and that Whittaker and Bendix, in their own self-interest, would then terminate Standard's distributor agreements for their commercial airline products. Rule 10b-5, however, does not place such an obligation on Bollo. It requires 'nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.' S.E.C. v. Texas Gulf Sulphur, 401 F.2d 833, 848-49 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). Here, PCC - itself the owner of a commercial airline, a sophisticated investor and an 'insider' of Standard - had unrestricted access to Standard's basic business data upon which its investment decision was manifestly based. That PCC availed itself of such access to the extent considered pertinent is amply shown by the evidence. Once the basic data was disclosed Bollo was under no further duty to anticipate PCC's interest in matters which did not assume importance until this action was commenced in March 1971."

On appeal, PCC appears to assert only one error in the district court's determination of its Rule 10b-5 claim, namely, that the district court relied on Radiation Dynamics and judged Bollo's 10b-5 liability on the basis of pre-contract events.

This argument is without merit.

PCC has tried to distinguish this case from Radiation Dynamics by contrasting the purported "irrevocability" of the contract in Radiation Dynamics with the conditional nature of

the contract of sale here. The district court found these to be distinctions without a difference (JA 861):

> "PCC's attempted distinction of this case from Radiation Dynamics, supra, does not postpone the 'commitment' date to the time of closing on September 18, 1969. Granted that PCC's 'obligation . . . to purchase the Balance of 80% of Standard Stock is subject to fulfillment of each of the following conditions,' PX 2, ¶ 6, it is nonetheless plain that 'in the classical contractual sense, there was a meeting of the minds of the parties' on December 20, 1968, marking 'the point at which the parties obligated themselves to perform what they had agreed to perform even if the formal performance of their agreement is to be after a lapse of time.' Radiation Dynamics, supra, at 891."

In Radiation Dynamics, the several defendants purchased a total of 6,500 TRG shares from Radiation Dynamics under "purchase agreements" which were simple letters of commitment signed by the defendant-buyers; there were "a series of delays" and the deal was "finally closed" one to two months after the purchase agreements were entered. Radiation Dynamics, supra, at 879. Whether or not there were any conditions unique to this deal, all bifurcated contracts/closings share a common and most important condition -- the transaction is conditioned upon the seller being able to deliver the securities and the buyer being able to deliver the consideration at the closing. Moreover, one aspect made the Radiation contract far from "unconditional" and "irrevocable" (PCC Br. p. 23). The letters under which some defendants committed to purchase a large number of the shares, one of

which is set out in full in the margin,* were expressly conditioned on plaintiff first acquiring those shares. In the instant case, the conditions included SEC and CAB approvals and Bollo's warranties to be made at, and as of, the closing.

In neither case therefore, was the contract of sale absolutely unconditional; in neither case were the conditions mere formalities.**

The issue of when the purchase or sale takes place for Rule 10b-5 purposes does not turn on the niceties of the passage of title, the technicalities of whether the conditions are precedent or subsequent or whether they are formalities or substantial. This Court made clear in Radiation Dynamics that the approach is a functional one, not a technical one, and thus is based on the purposes of Rule 10b-5.

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* The letter, dated July 10, 1964 and signed by defendant Goldmuntz, reads:

> "Of the 3,500 additional shares of DeVegh stock that may come under the control of Radiation Dynamics I will purchase 500 shares at $46.00 per share and Mr. Fred Mayer will purchase 200 shares at $46.00 per share provided this stock becomes available by the end of July 1964." Records & Briefs, U.S.C.A.2d Cir., 464 F.2d, Vol. 5 & 6 at 1149a.

In addition, plaintiff's letter of offer (dated July 15, 1964) recited that the "commit[ment] to sell 3,700 shares of TRG" was "subject to our acquiring said stock." Id. at 1273.

** At some point in time there may be so many conditions to a "deal" that there has been no real agreement or commitment to purchase or sell at all. This of course is not such a case, nor does PCC argue that the contract of sale was not a binding and enforceable commitment itself.

Appellant in Radiation Dynamics made the same argument that PCC makes here:

> "The appellant's initial contention that the proper date upon which to determine the materiality of information is the date, irrespective of when a party is bound by an offer or parties are bound by a contract to purchase or sell, the securities are transferred and paid for, disregards the clear and frequently stated policy of interpreting Rule 10b-5 so as to avoid reliance on formalism." Radiation Dynamics, supra, at 890.

The Court continued that securities legislation should be construed for this purpose "'not technically and restrictively, but flexibly to effectuate its remedial purposes'." Id. Since the function of Rule 10b-5 is to protect against uninformed decisions in the purchase or sale of securities, the functional approach requires its application at the time when the decision to purchase or sell is made. Conditions outstanding after the commitment is made, i.e., approvals by third parties or warranties necessitated by the fact that the sale also involves the sale of a business, are incidental to the commitment to purchase the security itself. A search for the time when all conditions incidental to a contract for sale of the securities are fulfilled would often result in 10b-5 duties being continued for years after the sale due to installment and contingent payouts and the like.

Thus, the "stage of the 'purchase or sale' transaction" at which Rule 10b-5 applies is determined not when all conditions are satisfied, but the time when "the parties are committed", when "the parties are bound", when there is "a meeting of the minds", a time when it is "readily understandable" that the commitment is

made, Radiation Dynamics, supra, 464 F.2d at 890-91.*

PCC argues that the warranty contained in the contract but required of Bollo "as of" the closing, constituted a condition which rendered the closing the real date of commitment. This warranty, paragraph 6(d) of the contract (JA 904), required Bollo physically to deliver at the closing additional warranties in a certification and represent the truth of the previous warranties as of the closing. In both respects, it imposed upon Bollo contractual obligations of disclosure with respect to events occurring between the contract and the closing.

But this argument misconstrues the difference between the contractual commitment a purchaser of securities may be required to undertake at the time of contract and his obligations under Rule 10b-5, which refers to "the purchase or sale of a security."

Rule 10b-5 was intended to protect investors prior to the time they committed themselves to purchase securities.**

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* In Barnett v. Kirshner, 527 F.2d 781 (2d Cir. 1975) this Court rejected the same argument made by PCC here. In Barnett, appellant argued that the execution of consent letters (accomplished after the actual sale of the securities) waiving restrictions on sale contained in a shareholder agreement was a condition which delayed the actual consummation of the sale. The Court held that the sale was not conditioned on the consent letters and therefore did not have to reach the question raised here but resolved by Radiation Dynamics, whether a condition that is a part of the sale operates to delay and extend the date of "commitment."

** As this Court said in Radiation Dynamics, supra, 464 F.2d at 891:

> "[10b-5] was not intended to provide an escape hatch through which disgruntled buyers or sellers could avoid transactions to which they had become committed but which had not been fully consummated by the formal exchange of the money or the securities agreed upon to be exchanged."

Business realities surely dictate that in a situation such as the case at bar, where the purchaser is a sophisticated investor, he may amply protect himself after commitment, and prior to closing, by obtaining the needed warranties from the seller, just as PCC did here. After contract, PCC could look out for its own interests by the insertion of appropriate contractual provisions, just as it did here. And if those provisions were violated, PCC had its remedies -- breach of warranty, common law fraud -- remedies PCC sought below (and now has abandoned on appeal).

For the foregoing reasons, we respectfully submit the district court correctly applied the principles of Radiation Dynamics to the case at bar.

II

THE DISTRICT COURT REGARDLESS OF THE RADIATION DYNAMICS DOCTRINE FOUND THAT PCC FAILED TO PROVE SECURITIES FRAUD WITH RESPECT TO THE POST-CONTRACT EVENTS

In any event, application of the Radiation Dynamics doctrine is, to a large extent, academic in this case. It is true that the district court reviewed the post-contract events -- the alleged loss of some of the expected jumbo jet business -- under the heading and the requirements of common law fraud and found PCC's proof wholly deficient. However, at the same time the district court explicitly held that two essential elements

of a federal securities fraud claim were lacking with respect to the post-contract events. Citing this Court's recent decision on Rule 10b-5 requirements, Titan Group, Inc. v. Faggan, 513 F.2d 234 (2d Cir.) cert. denied, 423 U.S. 840 (1975), and specifically referring to the post-contract events, the district court held:

> "[W]here both misrepresentations and material omissions are alleged, a plaintiff must show both materiality and reliance - a burden PCC did not meet here." (JA 871, emphasis added)

Faced with the district court's square holding against it on the federal securities issues, PCC next argues that the district court applied erroneous standards for reliance and materiality. But PCC's quarrel is really that the district court was too thorough in its analysis of the facts in this case which bear on those two requirements. PCC would ignore the many facts showing what the purchaser was genuinely interested in, considered important and actually relied on. Rather, PCC would determine materiality by looking at the facts allegedly misrepresented or not disclosed in a vacuum and would presume reliance despite what the evidence showed.

A. Reliance.

It is no answer to the district court's decision to say (PCC Br. p. 33) that reliance plays an insignificant role or is presumed in a non-disclosure case.

PCC asserted below, the district court dealt with, and PCC still argues on appeal more than just non-disclosure.

In fact PCC matches each of its asserted non-disclosures with an affirmative representation allegedly made by Bollo and allegedly false. Thus, PCC complains of non-disclosure of deteriorating supplier relationships, but it also asserts that "the purchaser was told that supplier relationships were excellent" and continued to "rely on those representations" (PCC Br. p. 32). And PCC claims non-disclosure of the allegedly dimming prospects for the jumbo jet business, but also asserts that it relied on affirmative representations allegedly made by Bollo in May 1969 to the effect that Standard was in an "excellent position on the 747 program" (JA 865; JA 975).

Where allegations of misrepresentations and material omissions are intertwined, proof of reliance is necessary to sustain a claim under Rule 10b-5.

Although "in instances of total non-disclosure, as in Affiliated Ute . . . a determination of materiality allows logically an inference of reliance," reliance is nevertheless a necessary element of the cause of action in a "case both of alleged misrepresentation and of material omissions." Titan Group, Inc. v. Faggen, supra, 513 F.2d at 239. Moreover, in Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27 (2d Cir. 1976) this Court and the district court treated a misleading financial report as a case of misrepresentation even though ten material omissions were involved as well, and required that plaintiff prove the misstatements were a "substantial factor" in the purchaser's decision, id. at 33.

Other factors make this case an appropriate one for requiring proof of reliance. In a face-to-face transaction, where the purchaser is sophisticated and experienced, indeed where it is in the business of buying and selling companies, has unrestricted access to the business information, books, records and personnel of the company (here PCC was an "insider" to begin with) and has demonstrated interest in some areas, none in others, the causative link between the alleged omission and any injury can be proved or disproved on the evidence and becomes a factual issue of paramount importance. In such a case, whether under the label of reliance, causation, materiality or plaintiff's duty of due care, the factors considered by the district court -- plaintiff's interests and investment objectives, its sophistication and access, and its actual investigation into areas of interest -- are relevant -- and here determinative -- of the issue.

The very factors which PCC claims were improperly taken into account below have been determinative of reliance in this Circuit. "We have here face-to-face dealings between sophisticated, well-advised corporate managers, rather than impersonal dealings among investors in an auction market. In this action proof of actual reliance . . . is an essential prerequisite. . . ." REA Express, Inc. v. Interway Corp., 410 F. Supp. 192, 199 (S.D.N.Y. 1976), reversed on other grounds, 538 F.2d 953 (2d Cir. 1976). In Pollak v. Eastman Dillon, CCH

Fed. Sec. L. Rep. ¶ 94,987 (S.D.N.Y. 1975), Judge Tenney found that plaintiff relied on "his own sophistication and expertise." Furthermore, plaintiff's status as an insider to begin with and his "ready access to the information involved" are highly relevant. Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975); Jackson v. Oppenheim, CCH Fed. Sec. L. Rep. ¶ 94,894 (S.D.N.Y. 1974).

The proper test of "causation in fact" still remains the one stated by this Court in List v. Fashion Park, Inc. 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965):

> "The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact. To put the matter conversely, insiders 'are not required to search out details that presumably would not influence the person's judgment with whom they are dealing.'" 340 F.2d at 463 (citations omitted, emphasis added)

B. Materiality.

PCC also argues that the district court committed legal error by applying an incorrect standard of materiality (PCC Br. p. 29). One of PCC's objections is that the "trial court made no reference to" the established test for determining materiality. But the district court cannot be faulted for having resolved the issue on the facts; there was no need to reach and recite the test for materiality. The trial court first determined what PCC knew about the major post-contract events, namely that McDowell, from his admission and his memo,

"was aware that big jet business would not be available to Standard" (JA 870). Thus, only two details were left arguably undisclosed -- the actual Whittaker and Bendix notices. The trial court's finding of the "absence of any material non-disclosures" (JA 870) is therefore a finding of fact that what may not have been disclosed was insignificant. "[O]nly the essence of a point need be disclosed, not the minute details." Mittendorf v. J. R. Williston & Beane, Inc., 372 F. Supp. 821 (S.D.N.Y. 1974) (Pollack, J.) (citation omitted).

PCC also objects to the trial court's methodology in looking at what information was actually disclosed and in examining PCC's actual interests in making its determination of materiality. Thus, PCC would prefer to isolate a particular event and judge its materiality in a vacuum. PCC's approach is simply wrong.

In face-to-face transactions, materiality is not purely an "objective" test.* In Titan Group, Inc. v. Faggen, supra, 513 F.2d at 239, this Court affirmed Judge Tyler's findings:

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* A "major factor in determining whether events are material is the importance attached to them by those who knew them". Mittendorf v. J. R. Williston & Beane, Inc., 372 F. Supp. 829 (S.D.N.Y. 1974). In this regard, it is significant that when PCC's tender offer was made in early 1969 Jerry Bollo, who had acquired Standard shares at a price of $4 per share (JA 314) did not accept a $16 tender offer price. By his own testimony, he was privy to all of the facts about Standard's business, which PCC claims were material omissions and which foretold a dismal future for Standard. Jerry Bollo, "one who knew the facts" held no such view.

> "that there was an abundance of evidence of the matters the plaintiff really considered important in entering this face to face transaction, that while the omissions might, in other circumstances, have been deemed material, the omissions were not material in these circumstances. These findings were not clearly erroneous, and correctly applied the applicable law."

See also Hirsch v. DuPont, CCH Fed. Sec. L. Rep. ¶ 95,645 (S.D.N.Y. 1976) where plaintiffs' sophistication, access to the information and actions during the negotiations reflected on materiality:

> "They did not consider any 1969 data important at the time and no reason exists to allow them to breathe materiality and reliance into such information now. See Titan Group, Inc. v. Faggen. . . ."

Finally, PCC's attempt to exclude from the determination of materiality the information actually disclosed is antithetical to the doctrine that materiality must be determined in the light of all the circumstances surrounding the transaction, including the total amount of information available. Spielman v. General Host Corp., 402 F. Supp. 190, 194-95 (S.D.N.Y. 1975), aff'd, 538 F.2d 39 (2d Cir. 1976); TSC Industries, Inc. v. Northway, 426 U.S. 438, 449 (1976). In Spielman, Judge Weinfeld wrote:

> "'Materiality' in the abstract is, of course, a meaningless concept. Materiality centers about the significance of the misstatement or omission of the fact under consideration to a reasonable investor's judgment in deciding to buy or sell. Thus, it can be given content only by considering all the circumstances surrounding the transaction. The determination of materiality is to be made upon all the facts as of the time of the transaction and not upon a 20-20 hindsight view long after the event." Spielman, supra at 194 (footnotes omitted).

C. The District Court's Findings Were Not Clearly Erroneous

The district court's findings on the federal securities issues, as we have already shown, were based on an extensive analysis of the testimony and a detailed review of the documentary evidence. As we have just demonstrated, the district court properly considered, on these issues, facts showing the information actually disclosed to PCC, the areas of PCC's interest, its motives and investment objectives and its total access to information about Standard's business.

PCC on this appeal attacks, directly and indirectly, many of the district court's findings of fact. But since those findings are not "clearly erroneous" and indeed are amply supported by the evidence, they may not be set aside. Since PCC attacks the findings on pre-contract events, despite its theory of legal error which only affects post-contract events, we will briefly review the findings under attack -- both pre- and post-contract.

(1) PCC claims that in the several years prior to the 1968 contract, Whittaker "was seriously contemplating a total cancellation of the Standard distributorship" (PCC Br., p. 31). But the facts -- as opposed to PCC's hindsight speculation -- consist of the 1967 purloined memos from an ambitious but junior employee and a single brief cancellation of the distributorship in 1963. The district court, however, found persuasive the

expansion of the distributorship in 1963 to the entire U.S., its renewal in 1967 and its lack of interruption through 1969 (JA 860). The trial court rejected PCC's assertion that the memos showed that the Whittaker relationship was "unstable" and that Whittaker was "contemplating cancellation," and concluded that the memos "cannot farily be regarded as 'fact'" (JA 843). Those findings surely are not clearly erroroneous.

(2) PCC's present claims with regard to "worsening" supplier relationships are without merit. For the evidence fully demonstrated PCC's almost total lack of interest in 1968-69 in the strength of Standard's contractual relationships with suppliers. No PCC representative ever asked to see the distributorship contracts which typically contained 30 day cancellation provisions. Mr. McDowell admitted that he did not become "knowledgeable" about the contracts or aware of the cancellation provisions until long after the closing -- not until the Bendix cancellation in 1970 (JA 137-38). Mr. Bonar admitted that he was told prior to the closing that the contracts were cancellable on short notice (JA 205-07), but he did not see fit to bring this to Mr. McDowell's attention in his written reports (JA 207-10) or otherwise (JA 139). Mr. Bonar's explanation for this -- that the legal relationships were not as important as the personal ones (JA 207-08) -- only reveals another area in which PCC showed no interest. PCC never investigated the strength of the personal relationships nor made any inquiry to determine what might happen

to these "personal" relationships if Bollo was no longer with the business (see JA 769-70).

It is against this backgound of "disinterest," that the trial court properly judged the materiality of and PCC's alleged reliance on the details of the supplier relationships.

(3) The district court's finding that the Bendix N & C discount reduction "had no substantial impact on Standard's business . . . . " (JA 857) was clearly correct. It affected only units -- 5% of Standard's business -- and once before N&C reduced, and then restored the discount rate on the introduction of new aircraft. (See p. 23, supra.)

(4) The Bendix E & C discount reduction reduced but did not eliminate profit on the products involved. Moreover, Standard's new business and increased sales thereafter (JA 845) ameliorated any substantial impact.

As to both discount reductions, however, even if the precise details were not known by PCC, the material facts -- the actual impact of shrinking profit margins -- were well known and thoroughly scrutinized. Mr. McDowell's May 1969 memo reported that earnings were down and sales were up for 1969 and specifically mentioned as a cause the inability to raise "selling prices and discounts" (JA 973).* Moreover, Mr. Bonar just prior to the closing reported the same phenomenon to McDowell -- 1969

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* PCC's assertion (PCC Br., pp. 35-36) that the only reason ever given to PCC for decreased earnings was the start-up of a new branch location is false and belied by McDowell's memo.

earnings would decrease about 60% despite increased sales (JA 1054). On this evidence, the trial court's finding that PCC "either knew the reasons or considered them immaterial" (JA 858) is not open to challenge.

(5) As to the Whittaker telex and Bendix N & C 1969 letter, PCC's knowledge was again the subject of careful scrutiny by the district court. McDowell's "fatal" admission that he knew about the loss of initial stocking on 747's and the conspicuous absence of any mention of new N & C 747 business in all of PCC's written analyses of new business prospects,* abundantly support the trial court's findings. Regardless of whether the details of the telex and letter may have been disclosed to PCC, it was "obvious" that PCC was "aware that big jet business would not be available to Standard" except as specified in McDowell's memo (JA 870). And the district court so found.

* * *

PCC was aware of all material facts. The few details that may not have been disclosed were of little interest or significance to PCC. In similar circumstances, Judge Weinfeld said:

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* See pp. 31-32, supra. These writings include McDowell's May 1969 memo (JA 975) analyzing new business prospects, his September 5, letter listing "anticipated . . . new sales" by name (JA 1048), and Bonar's notes after his September 1969 visit to Standard which also analyze new business but make no mention of any N & C 747 business (JA 1057).

"While courts must rigidly enforce the requirements that investors be fully and completely informed as to material matters, there is no requirement that information already adequately disclosed be spoonfed to them." Spielman v. General Host Corp., 402 F.Supp. 190, 206 (S.D.N.Y. 1975), aff'd, 538 F.2d 39 (2d Cir. 1976).

III

PLAINTIFF FAILED TO PROVE SCIENTER WITH RESPECT TO THE SECURITIES FRAUD CLAIMS

Having denied PCC's securities fraud claims by resolving issues of disclosure, materiality and reliance against PCC, the district court did not have to reach the element of scienter and, with one exception,* did not reach that issue. PCC'S appeal must fail, however, for the independent reason that it utterly failed to meet its burden of proving that Bollo acted "with intent to deceive, manipulate or defraud". Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

The record is barren of evidence, either direct or circumstantial, from which any inference may be drawn that Bollo was guilty of "knowing or intentional misconduct". 425 U.S. at 197. Taking PCC's evidence at its best -- that Bollo was aware of the Whittaker and Bendix notifications concerning discount reductions and provisioning of the jumbo

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* The only mention of scienter in the district court's decision (JA 872) was in connection with the court's review of PCC's claim that Bollo misrepresented Standard's inventory write-off policy. PCC has not asserted that claim on appeal.

jets and did not disclose these notifications to PCC -- nothing is shown in Bollo's conduct or his state of mind from which scienter can be inferred. His own testimony shows that he did not attribute to these facts the catastrophic consequences which PCC attempts today with the benefit of hindsight.

There is, moreover, no evidence showing that Bollo's reasons for not telling PCC these facts were born of an effort to conceal the facts from PCC and deceive it of the truth. Indeed, the evidence of Bollo's conduct, intentions and objectives at the time shows the contrary to be true -- he acted in a good faith attempt to provide PCC with whatever information it wanted.

The trial court found that Standard's business affairs were "an open book" (JA 858). The trial court found -- indeed it was admitted by PCC representatives -- that all of their questions were answered, all of their requests for documents were satisfied, and they had complete access to Standard's premises, its books and records, and its personnel (JA 854, 863).

It was also admitted by PCC's witnesses, the two officers of Standard that testified on PCC's behalf (Jerry Bollo and E. Rushia), that Bollo's instructions to Standard's personnel when dealing with PCC representatives were to provide those representatives with information they requested and truthfully answer all of the questions, see p. 17, supra.

If Bollo had at any time determined to embark upon a scheme to prevent disclosure of certain matters about Standard's affairs to PCC, he surely went about it in a way that was

calculated to guaranty disclosure. The Bendix N & C and E & C discount reductions, the Whittaker telex and the N & C letter of 1969 were anything but secrets at Standard (JA 327, 1166). The facts were widely known by Standard's management as well as its salesmen. Indeed the Bendix N & C 1969 notice regarding provisioning of jumbo jets was sent by Bollo to some 15 people at Standard (JA 1166).

If defendant Bollo had the slightest notion of preventing PCC from learning those facts, the last thing in the world he would have done was to give PCC representatives the unlimited opportunity to discuss Standard's affairs with others at Standard and to give them, as the district court found "unrestricted access to Standard's basic business data" (JA 863). Yet that is precisely what he did.

Evidence of scienter is totally absent in this record. Moreover, Bollo's good faith, as evidenced by his efforts to provide PCC with all of the information it required, is patent from the undisputed facts and the trial court's findings. Without else, PCC's failure to adduce evidence of scienter requires that the judgment dismissing PCC's federal securities fraud claims be affirmed.

IV

PLAINTIFF FAILED TO PROVE BREACH OF WARRANTY WITH RESPECT TO INVENTORY

With respect to PCC's claim that Bollo breached his warranty regarding "generally accepted accounting principles"

because Standard's inventory write-off policy was not in accord with such principles, the district court found (JA 876-77):

> "At the core of PCC's warranty claim is a construction of 'generally accepted accounting principles' which the court is unable to find reasonable in light of the nature of Standard's business and the circumstances surrounding the transaction between the parties. One can agree that the function of the certified public accountants who prepared Standard's financial reports was 'not merely to verify the correctness of the addition and subtraction of the company's bookkeepers.' See Herzfeld v. Laventhal, Krekstein, Horwath & Horwath, F.2d (2d Cir. 1976), Slip op., July 15, 1976, pp. 4991, 5006. The claim here, however, is not really directed to the accuracy or adequacy of the financial statements. Rather it challenges the business judgment of Standard's management in not taking greater advantage of liberal write-off opportunities at the close of each year. Such criticism, in hindsight, may be justified. It is no basis, however, for construing 'generally accepted accounting principles' as a warranty that all inventory which might have been written off was in fact so treated on the company's books.
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> * * *
>
> "The write-off procedure as described by Rushia was undeniably haphazard, but not out of keeping with a small company whose general management practices, as Bonar put it, 'are characterized by Paternalism with most of the top staff . . . having worked up through the ranks to their present position.' PX 9. Indeed, McDowell had also noted that Standard's 'financial man . . . is not much more than a competent bookkeeper.' PX 8, p. 4."

The district court went on to find (JA 877-78):

> "PCC's expert witnesses also opined no more than that Standard's inventory write-off method was inadequate. David Christopher, a

> partner of Price, Waterhouse & Company, PCC's outside auditors, while expressing the belief that Standard's 'methodology' was not consistent with generally accepted accounting principles, conceded there was no accounting textbook authority for writing off inventory in any given period of time as expressed in a two-year rule, a six-months rule or the like. Tr. 338-40. And William Carolla, the former president of one of Standard's major competitors, n. 17a supra, thought that a write-off formula, within the range of six months to two years, based upon business judgment would not be unreasonable Tr. 433."

Those findings were clearly correct.

The value of Standard's inventory as reported on its balance sheets was undeniably based on Bollo's evaluation of the inventory. Truly unsalable items were written-off and thrown away throughout the year and end-of-year write-offs of items with no probable sales potential took place regularly, if not in every year. Standard's outside auditors certified that the financial statements were prepared "in accordance with generally accepted accounting principles consistently applied" and thus did not disapprove of Standard's inventory policies. PCC simply failed to prove that Bollo exceeded the limits of business judgment or that Standard's practices did not result in a fair approximation of the value of its inventory.

Indeed, assuming arguendo that Standard's write-off practices were unacceptable, PCC still failed to prove an actual overvaluation of inventory and failed to prove damages. Use of a 2-year rule produced a total of $381,000

in additional inventory to be written off. But that write-off was based on a statistical sample; it was not a review of the actual inventory items.

Moreover, a 2-year rule, was according to PCC's own experts, merely one reasonable or acceptable practice. A 3-year rule was not wholly unacceptable to PCC's experts and we do not know whether use of that rule would have resulted in <u>any</u> significant write-offs. Moreover, a flexible rule depending on the item involved and the businessman's judgment of its sales potential would have met Mr. Christopher's test, if based on a complete review of all items. By comparison, Standard's methods may have been a little more haphazard, but may not have produced a very different result. In short, even if Standard's method can be criticized, the result -- the actual value reported for inventory -- has not been proven to have been materially misstated.

Finally, PCC did not translate a balance sheet adjustment with respect to inventory write-off into damages. As the trial court found, the price PCC paid for Standard shares was based on its evaluation of Standard's earnings; it was buying a going business, not a warehouse of inventory (JA 875).

Since PCC was buying an ongoing business, not a balance sheet, the effect of additional inventory write-offs on Standard's profit and loss statement should have been, but was not, considered. If an additional $381,000 in inventory had been written-off by 1969, profits <u>before</u> taxes would have decreased accordingly.

However, since taxes would have proportionately decreased as a result, and since the deduction for the inventory write-off on Standard's income tax returns was a non-cash expense, cash flow would have been increased. And that cash, if reinvested, could have produced profits in the future (JA 792-93).

PCC never attempted, or offered in proof, any analysis of the effect on cash flow of the inventory write-offs PCC argued should have been made in prior years.

In sum, the writing-off of a greater or smaller amount of inventory than might be deemed appropriate has both positive and negative effects. For this reason it is less than a burning issue to investors -- and, as the trial court found, it was virtually of no significance to PCC (JA 878-78a):

> "Finally it is manifest that PCC had no interest in the state of Standard's inventory until late in 1970 . . . ."

V

PLAINTIFF FAILED TO PROVE DAMAGES

Although the district court was not required to reach the issue, its judgment of dismissal must be affirmed on the independent ground that PCC failed to prove damages.

PCC's proof of damages came from the "expert" testimony of William Carolla, a businessman with experience in the aircraft parts business but no experience in the pricing of acquisitions and securities. He was given assumptions (JA 1086) which presumed the total elimination of Whittaker and Bendix

N & C and E & C sales and no expectations of new business.* His opinion was that Standard at the time of PCC's acquisition was worth only book value, about $5.13 per share.**

Mr. Carolla's past experience with acquisitions and his analysis in this case was limited to the factors and the data that the purchaser would investigate and consider in evaluating the subject company. But he had absolutely no experience with the methodology used to translate that data into a price. Thus, his experience in the aircraft parts business enabled him to estimate the impact on such a business of the factual assumptions of adversity given to him. However, in his experience it was always other people who took the data and translated it into a price (JA 480-82). In evaluating Standard, Mr. Carolla

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* The assumptions relating to Whittaker and Bendix used by Mr. Carolla are remarkably similar to the events during the "aviation recession" of 1970 -- the Whittaker and Bendix cancellations. This leaves no doubt that PCC's real complaint is Bollo's failure to predict the aviation recession and the resultant cancellations, see JA 863.

** Bollo's expert, Carleton Holstrom of Bear, Stearns & Co., testified (JA 763):

> "In my opinion, Mr. Carolla's approach was simplistic, and not in accordance with the conventionally used techniques in the investment community, or by companies expecting to acquire or negotiating to acquire other companies."

Mr. Holstrom was also put on the stand to testify that Standard's shares were worth more than book value given Carolla's assumptions and to describe the valuation technique used by the investment community -- applying an appropriate price/earnings multiple to the company's flow of earnings (JA 763-67).

looked at the adverse assumptions, estimated a reduction in sales caused thereby, and concluded that he would pay net worth for the company (JA 456-57). Although he may have heard of the technique of analyzing a company's flow of earnings and applying to it an appropriate price/earnings multiple, he had not used that technique and did not do so here.

The admission is fatal not only because that technique is the conventional method of evaluating an on-going business* but also because it was the technique used by PCC in evaluating Standard (as well as its competitors) and in pricing its acquisitions of Standard shares in 1967 and 1968 (JA 172, 175, 190, 670). The trial court found that the prices paid by PCC were calculated "with fair precision on the basis of Standard's earnings history" (JA 868-869).

Carolla's book value opinion ignored earnings history and expected earnings flow. It is not proof of what PCC would have paid for Standard shares in 1969, nor is it proof of what the value of Standard's shares was in 1969.

In addition to Mr. Carolla's failure to use conventional valuation techniques, his opinion was also inadequate because it rested on factual assumptions that were demonstrably erroneous:

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* The trial court found that "Bollo's purpose was to sell and PCC's purpose was to acquire a going business it would continue to operate as part of its own conglomerate enterprise" (JA 875). Book value is a valid method of valuation of a business only when the purchaser intends to liquidate the assets, not when he intends to continue the business and derive a flow of earnings from it (JA 775-76).

(1) The 1968 Bendix N & C discount reduction had an insignificant impact on Standard's business (see pp. 22-23, supra), but Mr. Carolla assumed it was "a serious deterrent to their sales in that area" (JA 461).

(2) Mr. Carolla computed the impact of the Bendix E & C discount reduction based on past sales without taking into account the increases in volume expected from the 1969 Eastern and United contracts (see pp. 24-25, supra); an increase in E & C sales did take place after 1968 (JA 845).

(3) Mr. Carolla never took into account the new business Standard was able to acquire after 1969, business the trial court found contributed to Standard's recovery from the "aviation recession" (JA 886, n. 29). This new business included:

(a) The Narco Radio distributorship; it began in 1969 and sales exceeded $1 million by 1972 (JA 894, 975),

(b) The Eastern wheel and brake requirements contract; it began in August 1969 and sales were estimated to be in excess of $1 million for the two year contract (JA 1046-47),

(c) The United wheel and brake business also beginning in August 1969 and estimated at $1 million (JA 1047),

(d) Other divisions of Bendix, which had provided little or no business in the past, achieved

some success on the 747 and provided new sales for Standard (JA 648-52), and

(e) The Atlas project -- an attempt in 1969 to obtain the 747 business of foreign airlines through maintenance consortiums (the Atlas group consisted of Lufthansa, Sabena, Air France and Alitalia) (JA 644-46, 974-75); PCC's refusal to provide the capital necessary for inventory prevented Standard from obtaining this business.*

(4) Mr. Carolla never took into account PCC's objectives as a buyer, objectives which were important in the acquisitions he had participated in (JA 483) and important in any securities valuation project (JA 771). Thus, he did not take into account the event that "triggered PCC's . . . acquisition" (JA 837), Premier's bid for control of Standard, which would either force PCC out or freeze it into a minority position. Mr. Carolla gave no weight to this risk, to the Premier tender offer price of $15 per share (which influenced PCC's price of $16), nor to the fact that in the December 1968, acquisition PCC acquired control of Standard.

Because of Mr. Carolla's failure to use the valuation techniques used conventionally and used by PCC in this

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* Mr. McDowell declined the request for capital because "the most severe credit crunch of the generation" was taking place (JA 157-58).

acquisition, and because of the substantial factual errors on which his opinion was based, PCC failed to prove damages.

CONCLUSION

For the foregoing reasons, the judgment of the district court should be affirmed.

Respectfully submitted,

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